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HOW TO VALUE AN ACCOUNTING PRACTICE

How do you determine a CPA firm's value? Which factors should be considered in the valuation process? These are just two of the many questions asked by practitioners who are considering merging their practices or acquiring another one. Expressing a firm's value as a percentage of its gross revenue is one frequently used method. There is, however, no standard formula to follow. Different factors must be considered in each individual situation.

One factor that should always be reviewed in assessing an offer for the sale of a practice is the quality of its earnings, including the number of hours required to generate the revenue. If lack of adequate records prevents such determination, very likely the practice should not be acquired at all, or, if it is, the purchase price should be lowered substantially or tied to subsequent collection.

In trying to reach a fair valuation, it is helpful to look at how larger CPA firms handle the withdrawal of partners. Generally, there is a provision in the firm's partnership agreement that requires such individuals to pay between 50 and 150 percent of the gross business taken.

Obviously, there is an industry trend to use gross volume as a basis for valuing an accounting practice. Some people in the profession believe, though, that the key element should be the percentage of profit before partner distribution. A firm that nets, say, in excess of 40 percent of gross revenue would generally command a higher price than a firm netting under 30 percent.

Rather than applying one multiplier to a firm's gross revenue, another suggestion is to apply different multipliers to each type of revenue (see below). Unfortunately, many firms do not measure profit by departments and it is often time-consuming to gather this information. Such an exercise, however, enables the purchaser to pay for the quality of earnings for each segment of revenue.

In a special report published by *CPA Digest* in August 1985, Sheldon Ames, a consultant to the profession, suggested the following multipliers for each component in order to take into account the quality and future value of the service line:

Segment revenue	Multiplier
Compilation	× .75
Review	× .85
Audit	× 1.00
Tax compliance	× .60
Tax planning	× 1.25
Continuing MAS	× 1.50

Add 10 percent to 15 percent for going concern and future market values of tangible assets.

There will be differences of opinion as to what percentage these multipliers should be. It would seem, though, that higher multipliers (over 100 percent) should be applied to more profitable areas of a practice. But in addition to applying multipliers and looking at the percentage of profit before partner distribution, the following subjective factors should also be considered.

Quality of partner earnings. If the net realizable hourly rate is in excess of $55 and the average partner earnings exceed $140,000 (this figure will change depending on the location), then a firm should grade well in this category. It is also impor-

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What's Inside...

Some Thoughts About a Successful First-Time Computerization

The issue for CPAs and clients alike is to put the microcomputer to use in an appropriate profit-generating or cost-containing mode, and to avoid the trap of using a computer simply because it seems to be the thing to do. Before installing a computer, I urge a careful analysis of the various office functions, pinpointing tasks that

- ☐ Are repetitive.
- ☐ Require a large amount of written input.
- ☐ Involve a lot of printing with little input of data. These would be tasks that require continual reproduction of reports, with only small changes for each version.
- ☐ Involve extracting data repeatedly from large files, or comparing two or more sets of data for multiple criteria.
- ☐ Require complex, multi-step calculations.
- ☐ Other people have successfully computerized.

You probably recognize elements in these areas, and specific examples abound. Payroll preparation meets many of the criteria set forth above. The production of mailing lists and standardized letters certainly fits in, although these items may not be a major part of most public accounting practices.

In each situation, a look at the specifics is important. Just because payroll activities have been successfully computerized elsewhere doesn't mean that the accounting office or department with six or seven employees needs or could justify putting its own payroll on a computer. It does not mean that computerizing the payroll is not a good idea, either, but that other alternatives might be better. On the other hand, a CPA firm or a client with forty-five staff on a weekly payroll basis may properly justify, and is probably already using, an in-house payroll-preparation software product.

The point is that the costs and benefits resulting from computerization need to be carefully considered for each application. Just because you have a computer and a printer in your office, doesn't mean you should buy a payroll package for a few hundred dollars, and then spend time writing five paychecks on the computer. In this particular example, an outside service bureau might be the answer.

Individual study of the proposed use, with careful consideration of the costs involved and the benefits to be obtained, applies to CPA practices as well as to clients' offices. In any first-time installation, CPAs who have not yet computerized or who have no experience should expect a certain amount of misery before happiness is achieved.

To minimize problems, we suggest focusing on a clearly justified use and ignoring all blandishments to throw in a little word processing, a little data base management, and so on. If you throw in all of these the first time around, the next thing you'll throw in is the towel! Get a reasonable, minimum amount of hardware and software, and set up the installation to successfully accomplish your intended use. There is plenty of time later to become a full-blown expert. Even beginners can look good to clients if they keep one achievable goal in mind.

The biggest pitfall for novices involves plans for expandable systems designed to run the entire business a few years down the road. This is usually a sales ploy to justify more than the minimum capability needed for the intended first use. Hold fast against excessive purchases until you have tried the world of computers to see if it fits your needs. There are always a few people or operations which are not ready to be computerized.

Proper organization and a correct mental attitude are essential. Beware of arguments that what you intend to buy is not upgradeable and will soon be obsolete, and that, therefore, you should buy a newer, bigger model. The computer sales people are right about obsolesence in one way. What you buy today *is* already obsolete. It will still work, however, and you can always use another terminal or another data entry station that can communicate with a more sophisticated system later on. If you keep these points in mind, you won't bite off more than you can chew and embarrass yourself or your clients. ☑

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Highlights of Recent Pronouncements

FASB Statement of Financial Accounting Standards

No. 102 (February 1989), *Statement of Cash Flows—Exemption of Certain Enterprises and Classification of Cash Flows from Certain Securities Acquired for Resale*

- ☐ Amends FASB Statement no. 95, *Statement of Cash Flows,* to exempt the following from the requirement to provide a statement of cash flows:
  1) Defined benefit pension plans covered by FASB Statement no. 35, *Accounting and Reporting by Defined Benefit Pension Plans,* and certain other employee benefit plans.
  2) Highly liquid investment companies that meet specified conditions.
- ☐ Requires that cash receipts and cash payments resulting from acquisitions and sales of the following be classified as operating cash flows in a statement of cash flows:
  1) Securities and other assets that are acquired specifically for resale and are carried at market value in a trading account.
  2) Loans that are acquired specifically for resale and are carried at market value or the lower of cost or market value.
- ☐ Effective for financial statements issued after February 28, 1989, with earlier application encouraged.

Statements on Auditing Standards

No. 63 (April 1989), *Compliance Auditing Applicable to Governmental Entities and Other Recipients of Governmental Financial Assistance*

- ☐ Establishes standards with respect to testing and reporting on compliance with laws and regulations in engagements under generally accepted auditing standards, *Government Auditing Standards,* and the Single Audit Act of 1984.
- ☐ Provides guidance on applying the provisions of SAS no. 53, *The Auditor's Responsibility to Detect and Report Errors and Irregularities,* and SAS no. 54, *Illegal Acts by Clients,* relative to detecting misstatements resulting from illegal acts related to certain laws and regulations.
- ☐ Provides guidance on reporting on compliance with laws and regulations and on the internal control structure in audits conducted in accordance with *Government Auditing Standards.*
- ☐ Provides guidance for testing and reporting on compliance with certain laws and regulations applicable to federal financial assistance programs in audits conducted in accordance with the federal Single Audit Act of 1984.
- ☐ Provides guidance for establishing an understanding with management regarding the type of engagement when engaged to test and report on compliance with other laws and regulations in connection with an audit of a governmental entity's financial statements.
- ☐ Effective, unless otherwise indicated, for audits of financial statements and of compliance with laws and regulations for fiscal periods beginning on or after January 1, 1989. Earlier application is permissible.

No. 62 (April 1989), *Special Reports*

- ☐ Prescribes a new special report form that parallels the form of the auditor's standard report in SAS no. 58, *Reports on Audited Financial Statements.*
- ☐ Requires the auditor's special report to state that the financial statements were prepared in conformity with a comprehensive basis of accounting other than generally accepted accounting principles (GAAP).
- ☐ Clarifies that there is no requirement to describe in the auditor's special report how the presentation differs from a presentation in conformity with GAAP.
- ☐ Clarifies the requirements for issuing a special-purpose report on special or incomplete presentations.
- ☐ Restricts the distribution of:
  1) Reports on financial presentations prepared to comply with a basis of accounting prescribed in a contract or regulatory provision that result in:
     a) presentations that are not in conformity with GAAP or another comprehensive basis of accounting (OCBOA) or
     b) incomplete GAAP or OCBOA presentations.
  2) Reports on compliance with aspects of contractual agreements or regulatory requirements related to audited financial statements.
- ☐ Supersedes SAS no. 14, *Special Reports.*
- ☐ Effective for special reports dated on or after July 1, 1989. Earlier application is permissible.

No. 61 (April 1988), *Communication with Audit Committees*

- ☐ Requires the auditor to determine that certain matters related to the conduct of an audit are communicated, either in writing or orally, to those having responsibility for oversight of the financial reporting process.

- ☐ Applicable to entities that have either an audit committee or other formally designated group equivalent to an audit committee, and to all Securities and Exchange Commission engagements.
- ☐ Requires the auditor to ensure that the audit committee receives additional information regarding the scope and results of the audit that may assist them in overseeing the financial reporting and disclosure process.
- ☐ Effective for audits of financial statements for periods beginning on or after January 1, 1989. Earlier application is permissible.

No. 60 (April 1988), *Communication of Internal Control Structure Related Matters Noted in an Audit*

- ☐ Supersedes SAS no. 20, *Required Communication of Material Weaknesses in Internal Control.*
- ☐ Supersedes SAS no. 30, *Reporting on Internal Accounting Control,* paragraphs 47-53.
- ☐ Provides guidance in identifying and communicating conditions that relate to an entity's internal control structure observed during an audit of financial statements.
- ☐ Defines items to be communicated as "reportable conditions" which are significant deficiencies in the internal control structure.
- ☐ Provides guidance on establishing, between auditor and client, agreed-upon criteria for identifying and reporting additional matters.
- ☐ Effective for audits of financial statements for periods beginning on or after January 1, 1989. Earlier application is permissible.

Quality Review

Standards for Performing and Reporting on Quality Reviews (March 1989)

- ☐ Provides the standards for performing and reporting on all reviews conducted under the AICPA quality review program.
- ☐ Applicable to firms enrolled in the AICPA quality review program, to individuals and firms who perform and report on such reviews, to state CPA societies that participate in the administration of the program, to associations of CPA firms that assist their members in arranging and carrying out quality reviews, and to the AICPA Quality Review Division.

Information for Members

Technical information

The primary responsibility of the twelve people who staff the Institute's technical information service is to answer members' questions on technical matters. They receive some 48,000 inquiries per year on accounting principles, financial statement presentation, auditing and reporting standards, and certain aspects of professional practice, excluding tax and legal matters. If you would like some assistance, we encourage you to call toll-free: United States, (800) 223-4158; New York State, (800) 522-5430.

Library services

The AICPA library's staff can offer assistance on a broad range of business topics. AICPA members anywhere in the U.S. may borrow from the library's extensive collection. For assistance, just call these toll-free numbers: United States, (800) 223-4155; New York State, (800) 522-5434.

Please note that toll-free calls cannot be transferred to other Institute departments.

Total On-Line Tax and Accounting Library (TOTAL) NAARS accounting and financial data library

Subscribers have access to different types of files in the Institute's NAARS library. These are corporate and local governmental annual reports, including financial statements, footnotes, auditors' opinions, and all current and superseded authoritative and semi-authoritative literature from the AICPA, FASB, GASB, and SEC. TOTAL subscribers can also access tax and other information. For further information, just call Hal Clark: (212) 575-6393.

Shrinking the "Black Hole" That Work Falls Into

The problem we faced was to manage the flow of work through our office more efficiently to permit quicker turnaround. The specifics of the situation were as follows.

Work is picked up from clients and brought to our office. This normally occurred without the information first being reviewed to see that it was complete and correct. Frequently, the client contact also neglected to note unusual events that occurred during the year, and to set a budget, a due date, and a clear objective.

At any given time, there were probably five or six jobs on each staff accountant's schedule, making it difficult to monitor each one for budget and due date. In addition, staff members found it difficult to set priorities because a different person may have been in charge of each engagement and all would be pressing them for completion of the work.

Consequently, staff members tended to work on what they perceived to be the "hottest" project until they needed information or needed to have a question answered. They tended not to spend time seeking information, though, because they always had several other "urgent" jobs to work on. The net result was that projects were put aside, and instead of a smooth flow of work through the review process, there was a flood of several jobs at the same time, creating a bottleneck or, worse, a "black hole" into which the work disappeared.

In reviewing this situation, we made the assumptions that a staff member can only work on one job at a time, that work time increases proportionally as the number of times a project is picked up and set down increases, and that it is the responsibility of the person who has contact with the client to assure that work is complete and correct when it is brought into our office.

Our solution to the problem

We decided that all work received in our office would first be sent to a coordinator so that projects could be properly planned. This would include all work to be delegated to a staff member, no matter whether it was brought in by a partner, a manager, or another member of the staff.

The planning process we established includes budgeting time, determining a due date, reviewing the information, notifying the client if additional items are needed, listing unusual items that may not be readily apparent to the staff accountant assigned to the job, determining the engagement objective (level of service, amount of disclosure, and whether it is comparative or not), and detailing the approach that should be taken. No work would be released to staff until the planning process had been completed.

To keep the time delay to a minimum, we made it mandatory that the accountant in charge makes sure all the necessary data is brought to our office. Each job would then remain in a backlog until a member of the staff was ready to begin work on it. In addition, staff accountants would have only one primary job on their schedules, which they would work on until it was ready for checking. At that time, another job would be released to them.

We saw a number of advantages to this process. First, because each staff member would have only one project to concentrate on at a time, there would be no confusion over priorities. That decision would be made by the release of the work to staff.

A second advantage that we saw was in the area of control. Staff members would have only one client file in their offices at a time, and we thought that control of each job would be enhanced because there would be only one job per person to monitor. We believed this would help us determine and smooth out workloads, too, and avoid having to switch assignments after already explaining the work in detail to someone else.

How our solution has worked

A smooth flow of work to the reviewer and approver allows them to better plan and execute those functions. In addition, the process resulted in a clearer idea of which jobs would be sent for checking and approval in a given week, and the approximate day on which they could be expected.

With each staff member having only one job to concentrate on with fewer interruptions, we have realized significant improvements in both quality and timeliness. And, just as important, staff has gained a sense of accomplishment on a regular basis by being able to finish a task on time.

We decided that an audit would be planned similarly to any other engagement. Because the work is usually performed at the client's place of business, however, we decided to do it in phases, and have each phase placed in a backlog for assignment to staff. During the time that staff accountants are assigned to a particular phase of an audit, it is the only job on which they work. In addition, we have the audit staff perform some of the less time-consuming tasks when scheduled to be in our office.

On occasion, we need additional information in order to complete an engagement. This can most often be taken care of with a telephone call to the client, confirmed by memorandum.

In situations where the client needs time to supply the information, the job reverts to an unassigned status and the staff person is given other work. It is then the coordinator's responsibility to follow up with the client to get the information.

Once this is received and found to be adequate to finish the job, the work is reassigned to the original staff member when he or she is available. The emphasis at our weekly scheduling meeting is, therefore, to determine which jobs will be completed that week and which will be released to staff.

One pitfall we encountered was that associates who had tended to believe they owned a particular job suddenly found someone else working on *their* accounts. With their sense of ownership diminished and not feeling the pressure of the backlog of work sitting in the coordinator's office, they did not have the commitment to the overtime hours that are necessary in tax season. As a result, we modified the system last tax season, to increase the workload, then changed it back again afterward.

There are numerous advantages to this method of controlling the workflow. We had always imagined we gained efficiency by having people perform the same jobs over a long period of time. When we moved work around under the new system, however, we found that not only the timeliness of service to clients generally improved, but the number of hours needed to complete the engagement was often reduced.

In addition, staff has become more creative and more thorough. Different people tend to look at the same job differently, resulting in new thinking and new ideas. And knowing they might not see the job again, they leave a clearer trail for those who follow.

The concepts for this procedure came out of my introduction to a book, *The Goal—A Process of Ongoing Improvement,* by Eli Goldratt,* which discusses ways of finding solutions to problems rather than continually fighting fires. Not only have we put the ideas to use in our practice, but we give the book to, and have started consulting with, manufacturing clients on the basic concepts. All in all, the process has forced the changes we wanted, and we are convinced it is the way to go. ☑

—by **Ronald C. Russell, CPA,** *Mesarvey Russell & Co., 1905 West North Street, Springfield, Ohio 45504*

**Editor's note:* The Goal—A Process of Ongoing Improvement *(Croton-on-Hudson: North River Press, 1986) is available for $15 a copy ($9 each for a case of 40 copies) from Common Sense Manufacturing, Inc., P.O. Box 3894, Suite 288, Milford, Connecticut 06460, tel. (203) 877-9253.*

How to Value an Accounting Practice *(continued from page 1)*

tant to note whether or not the firm has made an adequate investment in people and equipment.

Quality of personnel. Has the firm developed outstanding experienced personnel in all positions—both partners and staff—who will fit in from the standpoint of personality, talent, and professionalism? If so, it is a positive factor.

Location. If the firm is strategically located in a growing area or where the acquiring firm does not have significant presence, this will add to its value.

Nature of clientele. The firm may have several clients in specialized areas such as health care or banking. These would receive a high rating.

Type of services provided. If a firm provides management advisory services or other profitable services such as strategic planning, this should receive positive consideration. If the firm has expertise in an area that could strengthen a department in the acquiring firm, this would also be a plus.

Fee structure. The hourly rate factors are important. The average net cash realizable rate of the acquired firm should be within 20 to 25 percentage points of the rate for the acquiring firm.

Hours managed by partner. A problem exists if it is normal in the acquiring firm for each partner to supervise 10,000 hours and the partners in the candidate firm only supervise about half that number of hours. This would result in a low rating, unless the average realizable hourly rate is high.

Investment in office facilities and equipment. A significant investment in office facilities and computer equipment adds to a firm's potential value.

Quality of service. A firm should have quality

AICPA/CPE National Construction Industry Conference Set

In order to help individuals who provide services to the construction industry, the AICPA CPE division has developed a new conference that will be held on December 4-5 at the Hotel Intercontinental in New Orleans, Louisiana.

Topics include the construction process from bid to completion, audit risk assessment, the legal environment, winning contract claims, how a bonding company evaluates a contractor, the new tax environment, succession planning, construction risk management, construction accounting update, joint ventures, strategic planning, and valuing a construction company.

Recommended CPE credit is 16 hours. To register (VISA or MasterCard) or for additional information, call (800) 242-7269; in New York State, (212) 575-5696.

EXHIBIT

MERGER AND ACQUISITION REPORT CARD

Considerations	YES	NO
1. Quality of partner earnings		
2. Quality of personnel		
3. Location-strategic		
4. Nature of clientele (specialties)		
5. Nature services (MAS, strategic planning)		
6. Fee structure		
7. Hours managed by partner		
8. Investment in office facilities and computer equipment		
9. Quality of services (peer or quality review)		
10. Firm stability		

Excellent Prospect: 7 to 10
Average Prospect: 4 to 6
Poor Prospect: 0 to 3

Case study

Facts: ABC is a CPA firm that has a volume of $3 million with seven partners. The percentage of profit before partner distribution is 40 percent. It has had excellent growth and is a good quality firm. They are considering acquiring a $500,000 practice (XYZ firm) that has two partners and a net return of 20 percent before partner distribution. The managing partner of XYZ firm contacted ABC firm to determine whether there may be an interest.

The following report card was prepared for XYZ.

1. Quality of partner earnings—average earnings of $50,000	NO
2. Quality of personnel—no strong professionals, except for one partner	NO
3. Location—not strategic, firm is in the same city	NO
4. Nature of clientele—no specialties, normal services	NO
5. Nature of services—no MAS, strategic planning, or personal financial planning	NO
6. Fee structure—40 percent difference in hourly rate	NO
7. Hours managed by partner—$428,000 for ABC, $250,000 for XYZ	NO
8. Investment in office facilities and equipment—only one PC, no new equipment for the past five years	NO
9. Quality of service—partners are committed	YES
10. Firm's stability—no recent breakup	YES

The average partner earnings would be substantially lower than the earnings generated by ABC firm. XYZ firm has not developed outstanding personnel. There is no strategic location. The nature of clientele does not include any specialty and the firm recently lost business. There are no unusual services offered other than the traditional boilerplate services offered by CPA firms. The fee structure is not comparable with ABC and the average dollars managed are substantially different.

Grade: 2-YES/8-NO = Poor Prospect

Conclusion: In this case, the report card is not a good one, so there is really no goodwill value. However, a pro forma should be prepared to determine what costs would be eliminated if XYZ moved into ABC's facilities. Additionally, it would be advisable to prepare a client list and fee schedule to determine client profitability. Perhaps the firm is losing money on audits because it is not using audit software. Despite the report card, one must investigate whether, through better management, the bottom line can be enhanced. If such a possibility exists, the firm can decide whether to pursue the merger. Generally, however, if a firm grades low it is not a wise business decision to acquire the practice.

control documentation. The acquiring firm must inspect workpapers and tax returns of the acquired firm to determine that there is quality control. Because of the increased likelihood of lawsuits, no one wants to inherit problems.

Firm stability. Check to see how stable the firm is and whether partners have left recently and taken clients with them. Is there excessive partner turnover and has the firm been growing during the last four years?

To help put these considerations into perspective and arrive at a purchase price, the acquiring firm could use a merger report card, such as the one exhibited. If the candidate firm rates positively in all of the categories, it may warrant a premium, such as an advance cash payment to each partner, which would be in addition to the accrued capital account. A candidate firm's investment in developing outstanding people is a particularly important factor in determining the value of a practice, and, in certain instances, the average partner earnings figure is the critical component. Usually, the higher the average, the more the firm is worth.

Practitioners who are considering selling their firms often ask how they can determine that they are receiving proper value. One way is to ask the acquiring firm if it has a standard merger agreement and what the basis is of the unit awards.

A major problem leading to the demise of some firms that grew via mergers was the different deals accorded to different partners. This led to negative reactions from some partners who sold their practices and then realized that others had a better deal. Always make sure you are receiving value for what you have built over the years before proceeding with an acquisition or merger. An outside consultant can often be of help in this area.

With merger mania rampant, it is important to have options so that you can determine the best fit for your firm. In other words, consider more than one offer if you are selling, and look at more than one practice if you are acquiring. Although financial considerations are important, it is the trust and integrity of the firms involved that will determine if a merger or acquisition is successful. If you wonder whether you would be comfortable with the people with whom you are negotiating, you might remember the cocktail party test as described by J. Curt Mingle, CPA. (See "Making the Marriage Last" in the August 1984 issue of the *Practicing CPA.*) ☑

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Editor's note: Mr. Gallagher is the author of Merging Your CPA Firm *(Colorado Springs: McGraw-Hill, 1988), from which this article and exhibit are excerpted.*

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